

## CREDIT OPINION

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# Seattle (City of) WA Electric Enterprise

## Update Following Affirmation of Aa2 and Stable Outlook

### Summary

The City of Seattle, WA's (Seattle) Electric Enterprise's (Seattle City Light or SCL: Aa2/stable) credit profile considers the wealthy and diverse service area covering the City of Seattle (UTGO Aaa/stable) and surrounding communities, SCL's historical willingness to raise rates when necessary, and credit supportive financial policies including the Rate Stabilization Account (RSA). Other credit supportive factors are SCL's ownership of low-cost hydro generation, long-term power supply contract with Bonneville Power Administration (BPA, Aa2/stable), competitive retail rates, and SCL's participation in the City of Seattle's consolidated money pool.

The utility's credit quality also captures long term credit challenges including a historical trend of declining electric load growth relative to the service area's strong economic growth, hydrology risk, wholesale price exposure, and SCL's increased debt burden that has funded its historically large capital improvement plan (CIP). Also considered in the rating are financial metrics historically in the 'A' category with Moody's adjusted debt service coverage ratio (DSCR) averaging around 1.60x and days cash on hand averaging 140 over the last three years.

For 2020, consequences from the coronavirus outbreak have negatively impacted the utility's service area including reduced retail demand by 9.9% in April and 7.7% in May 2020 on a weather adjusted basis while the unemployment rate (preliminary) sharply increased to 13.2% (US rate at 13.3%) as of May 2020 compared to a low of 2.2% in February 2020. As part of the utility's response to the coronavirus, SCL has suspended disconnection for non-payment, implemented operating and capital expense reductions, and does not intend to put into effect a previously planned 3.6% retail rate increase in January 2021. The latter action is credit negative.

While the service area has experienced severe consequences from the coronavirus outbreak, the utility expects the financial impact to be manageable with retail revenue declining around 1.3% compared to 2019, which considers forecasted full year retail load loss mostly offset by the 5.5% base increase implemented in January 2020 and an increase to the RSA surcharge. Overall costs are also expected to increase driven by higher assumed uncollectible revenue. The net impact to the utility's financial metrics is a drop to Moody's adjusted DSCR to between 1.40x to 1.50x for 2020 and a return to 1.50x or higher thereafter. The DSCR improvement starting in 2021 assumes strong expense management followed by demand recovery and implementation of retail rate increases starting in 2022. The utility's forecasted resumption of necessary retail rate increases remain a key rating support consideration

and a weakening to its willingness to raise rates after 2021 would likely have a negative implications for the utility's rating.

To the extent the near term coronavirus related consequences are more severe than expected, the utility maintains sufficient internal and alternate sources of liquidity. At year-end 2019, SCL had 151 days cash on hand that is further supplemented by shared participation in the City of Seattle's consolidated money pool that totaled \$1.395 billion net of enterprise (\$2.447 billion gross) and by the current over funding of the utility's debt service reserve. On the former, the City of Seattle's willingness to provide liquidity support to SCL by lending through the money pool has been demonstrated in the past. Looking forward, internal liquidity is expected to drop to around 100 days cash on hand because of a planned defeasance of \$100 million of existing bonds using a portion of operating cash.

### Credit strengths

- » Strong and diverse service area anchored by the City of Seattle
- » Demonstrated willingness to set rates including the RSA mechanism
- » Ownership of low cost hydro and contracted power from BPA
- » Competitive retail rates
- » Liquidity support through the City of Seattle's consolidated money pool

### Credit challenges

- » Decoupling of retail electricity demand from economic growth
- » Large, ongoing capital spending program
- » Hydrology and wholesale market risk
- » 'A' category financial metrics

### Rating outlook

The stable outlook considers the benefit of the RSA mechanism, our expectation that the utility will maintain well over 90 days cash on hand and adjusted DSCR returning to 1.50x or higher after 2020. The stable outlook also reflects the expected resumption of necessary rate increases after 2021 to achieve forecasted financial metrics, the city council's historic willingness to support the utility's credit quality, and SCL's participation in the City of Seattle's consolidated money pool.

### Factors that could lead to an upgrade

- » Internal liquidity comfortably exceeding 200 days cash on hand and adjusted DSCR exceeding 2.0x on a sustained basis.

### Factors that could lead to a downgrade

- » Weakening of financial policies including chronic net draws on the RSA account
- » Willingness to increase rates diminishes
- » Inability to sustain at least 90 days cash on hand or Moody's adjusted DSCR of at least 1.50x on a sustained basis
- » Liquidity support through the City of Seattle's money pool is weakened
- » Severe and sustained deterioration of underlying regional economy

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## Key indicators

Exhibit 1

### SEATTLE (CITY OF) WA ELECTRIC ENTERPRISE

	2015	2016	2017	2018	2019
Total Sales (mWh)	12,706,001	13,224,890	13,103,832	12,403,350	12,439,054
Debt Outstanding (\$'000)	2,070,800	2,118,100	2,345,500	2,491,600	2,567,100
Debt Ratio (%)	60.1	58.3	58.4	57.2	54.6
Adjusted Debt Ratio (%)	81.1	78.6	76.2	74.1	70.2
Total Days Cash on Hand (days)	152	104	130	138	151
Fixed Obligation Charge Coverage (if applicable)(x)	1.23	1.49	1.60	1.55	1.62

Source: Moody's Investors Service and Audited Financial Statements

## Profile

Seattle City Light is a department of the City of Seattle, which operates a utility system that primarily generates and delivers electricity to approximately 470,380 customers in the City of Seattle and several surrounding communities under franchise agreements. The City of Seattle is in the western part of Washington State and is a commercial hub for the Pacific Northwest. SCL's service area is comprised of 131 square miles and has a population of approximately 940,000.

## Detailed credit considerations

### Service Area and System Characteristics

#### Strong and Diversified Service Area in the Economic Heart of the Region Facing Sharp Economic Hardship

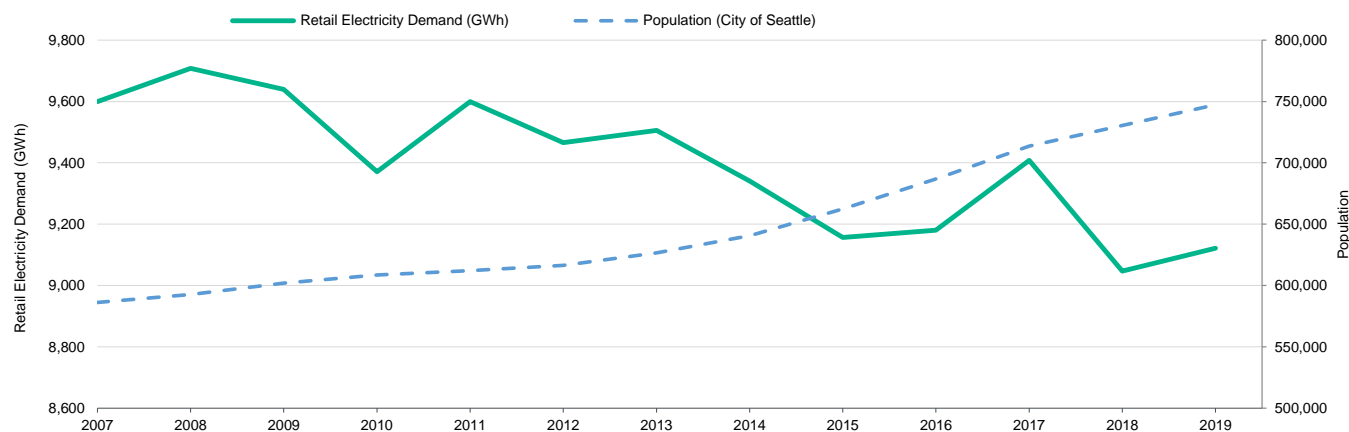
The utility derives around 90% of its revenues from the sale of electricity to retail customers in the City of Seattle and surrounding communities, which has 940,000 residents. Service in the surrounding communities is provided under franchise agreements and several are currently under negotiation for extension. SCL's rate process is governed by the city council and is not regulated by the State regulatory board.

The City of Seattle is located in King County, WA (UTGO Aaa/stable), which is the economic heart of the Pacific Northwest region. The City of Seattle has socioeconomic figures that are amongst the strongest in the country with estimated median family income at 162.9% of the U.S. national average. Software development and aircraft manufacturing are key components of the local economy, and the area serves as the headquarters of or major operating base to some of the world's most well-known international corporations, including Amazon (A2 positive), Boeing (Baa2 negative), Microsoft (Aaa stable), and Starbucks (Baa1 negative).

For 2020, consequences from the coronavirus outbreak has negatively impacted the utility's service area including reduced retail demand by 9.9% in April and 7.7% in May 2020 on a weather adjusted basis while the unemployment rate (preliminary) sharply increased to 13.2% (US rate at 13.3%) as of May 2020 compared to a low of 2.2% in February 2020. As part of the utility's response to the coronavirus, SCL has suspended disconnection for non-payment, implemented operating and capital expense reductions, and does not intend to put into effect a previously planned 3.6% retail rate increase in January 2021. The latter action is credit negative. Currently, the utility expects demand to remain depressed through 2021 with a strong return in 2022 and full normalization of demand by 2023.

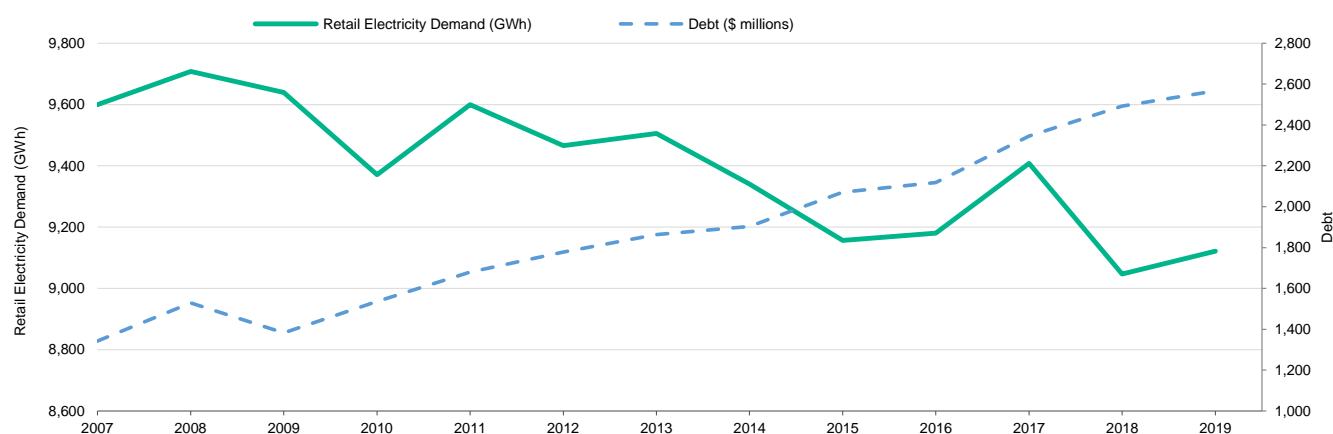
Aside from the coronavirus, the utility also continues to face a long term challenge of a growing service area that drives a large capital program but declining electricity demand (see Exhibit 2 and 3).

Exhibit 2

**Seattle's Electricity Demand Has Decoupled From Economic and Population Growth**

Source: Census Bureau and Moody's Investors Service

Exhibit 3

**Debt Has Grown Even as Retail Electricity Sales Have Declined Over Time**

Source: Moody's Investors Service and Audited Financial Statements

The decoupling between economic growth is caused by energy efficiency initiatives that ultimately pressures retail revenues. While electrification of transportation is forecasted to be an important source of new demand by the 2030s, overall demand is expected to decrease over time until then. These factors highlight the continued importance of the utility's willingness to raise rates to ensure expected financial performance.

**Ongoing Demonstrated Willingness to Raise Rates Remains a Key Credit Support Anchor**

Seattle's city council has shown a demonstrated willingness to use its authority to raise retail rates to support SCL's financial condition and the city's willingness is considered an essential credit support factor to ensure that the utility's financial performance is according to expectations. Historically, the utility has implemented annual base rate increases with the most recent comprising of a 5.5% increase as of January 1, 2020. In addition to the base rate changes, SCL has a separate automatic rate adjustment mechanism for any BPA cost changes and a separate surcharge according to the RSA (see liquidity section regarding RSA mechanism).

Historically, competitive retail rates and a strong economy supported SCL's rate raising ability. SCL's average system rates that are below the main investor owned utility in the area and moderately above the State weighted average.

Looking forward, the utility planned further annual base rate increases including a 3.6% increase starting in January 2021. However, SCL no longer plans to increase rates in 2021 given the severe, coronavirus related economic downturn. Currently, the path of future rate

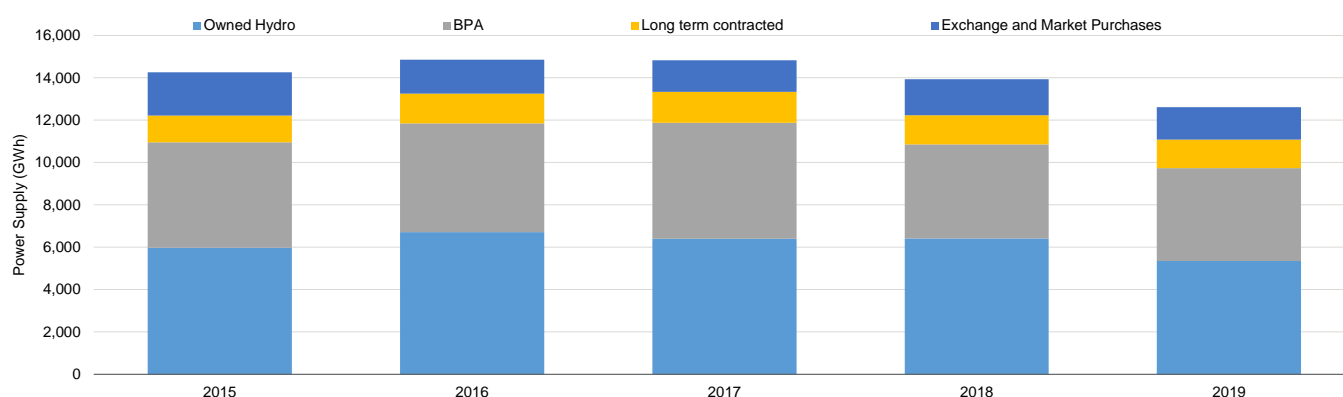
increases is unclear since the uncertain economic outlook has led the utility to put on hold its 2021-2026 strategic plan. We currently incorporate the assumption that the city will approve rate increases starting in 2022 and onward to maintain the utility's forecasted financial metrics. The utility has implemented major rate increases during times of stress such as the 2000-2001 energy crisis and the last recession. However, to the extent the city's willingness to raise rates weakens and SCL fails to achieve forecasted financial metrics, it would have significant negative credit implications including a negative rating action.

### Hydro Dependent Power Supplies

Typically, SCL receives approximately 40% to 45% of its power from owned hydro generation, 30% to 35% from BPA, and the remainder from other sources such as the wholesale market, exchange agreements, and other various long-term contracts (see exhibit 4 below).

Exhibit 4

#### Hydro power dominates power supply



Source: Issuer

Owned generation totals 1,872 MW of nameplate hydro dams and primarily consists of the 1,022 MW Boundary hydro project (Boundary Project) and the 802 MW Skagit hydro projects (Skagit Projects). The Boundary Project is located in Pend Oreille County in Washington State and its FERC license expires in 2055. The Skagit Projects consist of three hydro projects that operate as one system since they are located on the same ten-mile section of the Skagit River. The Skagit projects' FERC license expires in 2025. SCL also has smaller hydro facilities totaling 48 MW. While the hydro dams provide zero carbon emitting power, it also represents a volatile supply source given the variability of regional hydrology.

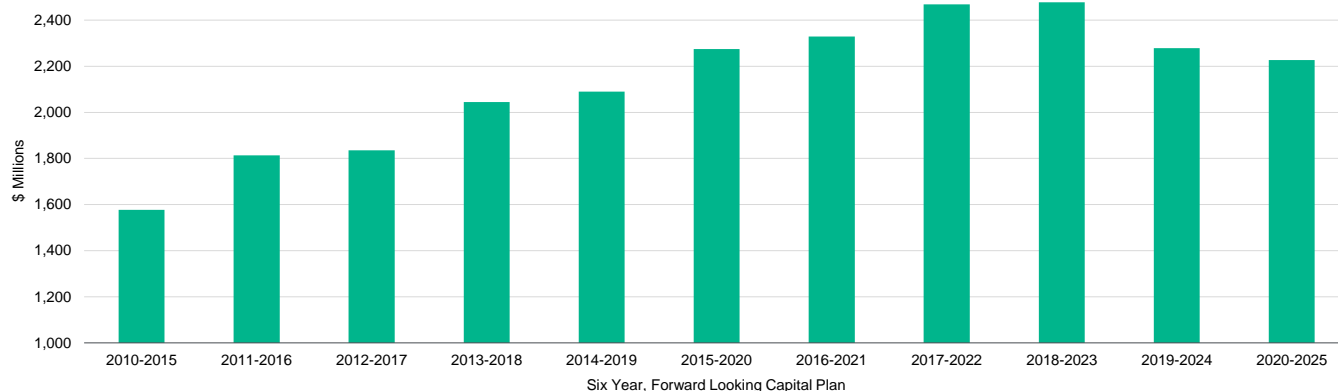
SCL also has a long-term contract with BPA that provides firm power (Block) shaped through the year. SCL also has long-term agreements with other hydro projects such as the Priest Rapids project and long-term agreements with wind, landfill and biomass projects that contribute to Washington State's renewable portfolio standards. Looking forward, SCL expects to meet increased state renewable requirements primarily through the 'no load growth' alternate compliance option. Additionally, the utility's portfolio mix positions SCL to meet the State's requirement to supply 80% of its retail sources with non-carbon emitting power by 2030 which rises to 100% by 2045.

### Large Capital Spending Plan

Through 2018, SCL's 6-year forecasted capital program has grown steadily on a rolling basis from \$1.6 billion for the 2010-2015 period to peaking at \$2.5 billion for the 2018 to 2023 period (see Exhibit 5). Since 2019, the utility reduced its spending with its latest six-year, forward looking plan at around \$2.2 billion. The reduction reflects a combination of project cancellations and the deferral of noncritical work according to its 2019 strategic plan.

Under SCL's latest capital expending plan, the largest focus of its capital program continues to remain on the distribution system at around \$1.15 billion, which includes replacement of underground and overhead equipment. Forecasted power supply related expenditures total \$402 million and include environmental mitigation and plant improvements.

Exhibit 5

**Growth to Utility's Rolling 6-Year Capital Program Has Flattened Since 2019**

Source: Official Statements

SCL plans to fund these expenditures approximately 51% with debt, 34% from operations and the remainder from capital contributions. The sizeable program and associated increase in debt remain credit challenges for SCL especially as electricity demand has decoupled from economic growth as previously highlighted in Exhibits 2 & 3.

**Debt Service Coverage and Liquidity****Debt Service Coverage Ratios Likely Will Weaken in 2020**

For 2019, the utility financial performance improved relative to 2018 with Moody's adjusted debt service coverage ratio (DSCR) of 1.62x and liquidity of 151 days cash on hand compared to DSCR of 1.55x and liquidity of 138 days cash on hand in 2018. Higher retail revenue was the major driver of the improvement based on both a 5.8% retail rate increase in January 2019 and slightly higher retail demand.

For 2020, while the service area has experienced severe consequences from the coronavirus outbreak, the utility expects the financial impact to be manageable with retail revenue declining around 1.3% compared to 2019, which considers retail load loss mostly offset by the 5.5% base increase implemented in January 2020 and an increase to the RSA surcharge. Overall costs are also expected to increase driven by higher assumed uncollectible revenue. The net impact to the utility's financial metrics is a drop to Moody's adjusted DSCR to between 1.40x to 1.50x for 2020 and a return to 1.50x or higher thereafter. The DSCR improvement starting in 2021 assumes strong expense management followed by demand recovery and implementation of retail rate increases starting in 2022. The utility's forecasted resumption of necessary retail rate increases remain a key rating support consideration and a weakening to its willingness to raise rates after 2021 would likely have a negative implications to the utility's rating.

**LIQUIDITY**

SCL's standalone liquidity consists of unrestricted funds and balances in the RSA account that equaled 151 days cash on hand at year-end 2019, which was stronger than 2018's 138 days cash on hand. Supporting the utility's liquidity is the RSA mechanism that provides a soft floor to liquidity. The RSA targets \$100 million to \$125 million cash balance and an automatic surcharge is triggered if the cash balance drops below specific thresholds (see exhibit 6). If the RSA is above \$125 million, excess funds could be used to refund ratepayers or be used for other purposes such as capital expenditures.

Exhibit 6

**RSA Minimum Balance and Quarterly Surcharge Thresholds**

<b>RSA Balance</b>	<b>Automatic Quarterly Surcharge (%)</b>
≤ \$90 million	1.5%
≤ \$80 million	3.0%
≤ \$70 million	4.5%
≤ \$50 million	City Council must initiate rate review within 45 days and determine actions to replenish RSA to \$100 million within 12 months

Source: Issuer

Moody's views the RSA as a key risk management tool that supports minimum liquidity and financial metrics. That said, the RSA mechanism itself is insufficient to ensure at least 90 days of liquidity or adjusted DSCR of 1.5x.

For 2020, SCL's liquidity is expected to drop to around 100 days cash on hand and remain around the lower level. The liquidity decline is caused by a planned defeasance of \$100 million of existing bonds using a portion of operating cash. Supplementing the utility's internal liquidity is its participation in the City of Seattle's consolidated money pool and current overfunding of the debt service reserve. On the former, City of Seattle's consolidated money pool, totaled \$1.396 billion net of enterprise funds (\$2.42 billion gross) as of March 31, 2020. Seattle's Director of Finance is authorized to make loans to Seattle's various enterprise funds including SCL for up to 90 days. For loans beyond the 90-day period, city council approval is required. Loans bear interest at the cash pool's rate of return. The City of Seattle's willingness to provide liquidity support to SCL via the money pool has been demonstrated on several occasions, including during the 2001 power crisis when SCL borrowed up to \$107 million from the money pool and again in 2010 when SCL borrowed \$14 million.

**Debt and Legal Covenants****DEBT STRUCTURE**

Most of SCL's debts are traditional fixed rate obligations that fully amortize over time. The only exception is around \$200 million variable rate debt that SCL issued in 2018. There is no credit enhancement such as a letter of credit supporting the variable rate debt.

**DEBT-RELATED DERIVATIVES**

SCL does not have any debt related derivatives.

**PENSIONS AND OPEB**

SCL participates in the City of Seattle's single-employer defined-benefit public employee retirement plan (SCERS). Moody's calculates the utility's adjusted net pension liability (ANPL) for FY 2019 relating to its proportionate share of SCERS to be around \$695 million, compared to the utility's reported proportionate share of the net pension liability of around \$322 million. Moody's adjusts the reported pension liabilities of entities that report under governmental accounting standards, to enhance comparability across rated issuers. Under governmental pension accounting, liabilities are discounted using an assumed rate of investment return on plan assets. Under our adjustments, we value liabilities using a market based discount rate for high quality taxable bonds, a proxy for the risk of pension benefits.

**Management and Governance**

Seattle's mayor and city council has ultimate authority over SCL and approves SCL's budget, sets rates, and approves any financing. A separate City Light Review Panel comprised of SCL's customers reviews and assesses SCL's strategic plan, financing policies and rates. SCL's rate process is not regulated by the state regulatory board.

General Fund Transfer

SCL pays a utility tax to the City of Seattle equal to 6% of gross revenues from retail sales, less certain adjustments. The utility tax is subordinate to debt service. SCL also pays a separate state public utility tax equal to 3.8734% of gross revenues from sales within the State, less certain adjustments.

### Legal Security

SCL's bonds are secured by a pledge of the net revenues of SCL and covenants require that the City of Seattle set rates to fund debt service, operating costs and other costs to maintain the system. Moody's considers the rate covenant to be weaker than typical for similar issuers. For additional indebtedness, SCL is required to meet a 1.25x DSCR based on net system revenues incorporating draws from and deposits into the RSA. Furthermore, the bonds have a debt service reserve for all parity bonds sized to the lesser of maximum annual debt service or reasonably required reserve or replacement fund per the tax code. The reserve is currently sized to 125% of average annual debt service (excluding variable rate debt). Post issuance, the reserve is expected to be funded with a \$71.5 million surety from Assured Guaranty Municipal Corp (insurance strength: A2-stable) and \$146.8 million of cash. We recognize the current reserve balance is above the estimate minimum requirement of \$163.5 million due to incremental funding by the utility in anticipation of the surety expiring in August 2029. Since the overfunded amount is not needed until 2029, the excess funds can be available to the utility for general use until then.



## Rating methodology and scorecard factors

Moody's evaluates Seattle City Light under the US Public Power Electric Utilities with Generation Ownership Exposure methodology and the scorecard indicated outcome is Aa2, in line with its current Aa2 rating.

The grid is a reference tool that can be used to approximate credit profiles for public power with generation ownership in most cases. However, the grid is a summary that does not include every rating consideration. Please see US Public Power Electric Utilities with Generation Ownership Exposure for more information about the limitations inherent to grids.

Exhibit 7

### Scorecard

Factor	Subfactor	Score	Metric
1. Cost Recovery Framework Within Service Territory		Aaa	
2. Willingness and Ability to Recover Costs with Sound Financial Metrics		Aa	
3. Generation and Power Procurement Risk Exposure		A	
4. Competitiveness	Rate Competitiveness	A	
5. Financial Strength and Liquidity	a) Adjusted days liquidity on hand (3-year avg) (days)	A	140
	b) Debt ratio (3-year avg) (%)	A	73.5%
	c) Adjusted Debt Service Coverage or Fixed Obligation Charge Coverage (3-year avg) (x)	A	1.59
Preliminary Grid Indicated rating from Grid factors 1-5		Aa3	
		Notch	
6. Operational Considerations		0.0	
7. Debt Structure and Reserves		1.0	
8. Revenue Stability and Diversity		0.0	
Grid Indicated outcome:		Aa2	

Source: Moody's Investors Service

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